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**Trash or treasure? Dumped index stocks could be investing opportunity**
By Rob Burgess
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Conventional wisdom in portfolio management suggests following the big indexes. But data and analysis shared in a recent webinar held by Research Affiliates, a Newport Beach, California-based investment firm, indicates that the stocks dumped, or deleted, from indexes could actually present opportunities for some investors.

In the Oct. 24 session hosted by Brent Leadbetter, partner and head of solutions distribution, Rob Arnott, founder and chairman of the firm, said Research Affiliates' data shows that historically, these index deletions lag the market by more than half in the year leading up to their removal from an index. Still, they historically outperform the market for at least five years after the breakup.

In September, Arnott launched his firm's first exchange-traded fund — the Research Affiliates Deletions ETF (NIXT), which buys companies recently deleted from major indexes and  holds them for about five years, or until they reenter a benchmark.

Arnott said in the webinar that "gold-standard," cap-weighted indexing has two Achilles' heels: It inherently overweights overvalued companies and underweights undervalued companies relative to an unknowable fair-value-weighted portfolio. Also, it typically adds high-flying growth stocks after a period of outperformance and drops feared deep-discount value stocks after underperformance. Flip-flops — in which an index addition was later dropped — and vice versa, abound.

Recent losers have historically outperformed recent winners. According to Research Affiliates analysis of performance of stocks added to or deleted from the S&P 500, relative to the market from October 1989 to June 2021, stocks added to the index have historically outperformed discretionary deletions by over 70% in the period covering 12 months before the change was announced. This has typically widened by another 13.4% between the announcement and the day after the trade date. Historically in the 12 months after the trade date, the situation reverses and deletions historically outperform additions by over 22%.

Additions and deletions are the "epitome of performance-chasing," said Arnott. He said Research Affiliates' index deletion strategy is "lightly related" to the well-known "index effect." Historically, stocks that are added or dropped from an

index experience positive or negative excess returns in the days immediately before they are officially added or dropped. He said the index effect is diminishing. The key difference is Research Affiliates' strategy is about the long-term mean reversion of deletions. It is concerned with the performance over years, not days.

"Stocks that have been savaged do tend to bounce back, especially if they're extreme outliers," said Arnott. "And the stocks that are added to or dropped from an index do tend to be extreme outliers."

The three stages of deletion are decline, in which stocks underperform the market by around 50% over year; deletion, in which it is removed from the index; and rebound, which includes long-term mean-reversion, that historically outperforms the market for around 28% over the following five years.

"Stocks that have dropped tend to have performed horribly and then tend to perform rather well," said Arnott.

Discretionary deletions are routinely deep-discount value stocks, in which the index sells low, with a subsequent performance rebound post deletion. Additions are routinely high-flying growth stocks, in which the index buys high, with a subsequent performance reversion post-addition. The index makes buy-high and sell-low trades for investors. Investors miss out on subsequent deletions' upward mean reversion and instead hold additions that typically underperform.